

Arabica Coffee Futures Long - December 2018

Executive Summary

Arabica Coffee (KC) is down more than 16% this year driven by large speculators increasing short positions to record levels. The consistent speculative selling helped generate five negative price targets all of which were achieved last week with exhaustion of the trend evident across multiple time frames. Market structure and technical analysis mandate offsetting short futures positions and reveal an opportunity to begin building early, closely managed long positions in December futures: KCZ18.

The record short speculators are in a precarious position heavily shorting the commodity on margin with commercial traders set to benefit from a rebound in prices. Speculators will begin offsetting their short positions, especially those recently established.

Previous long entries have proven challenging, good for little more than occasional day trades with discipline and tight stops. The exhaustion of selling and early signs of accumulation are signs of a trend change favoring long speculation. The position will be challenged by coffee's correlation to the volatile Brazilian Real inverse to the recently strengthening U.S. Dollar.

Market Structure

Market structure measured by Commodity Futures Trading Commission (CFTC) Commitment of Traders (COT) data is at record extremes and poised for a long reversal.

Commercial Position

Commercial market participants are best informed about coffee fundamentals and are record net long in the weekly chart [Figure 1](#) below.

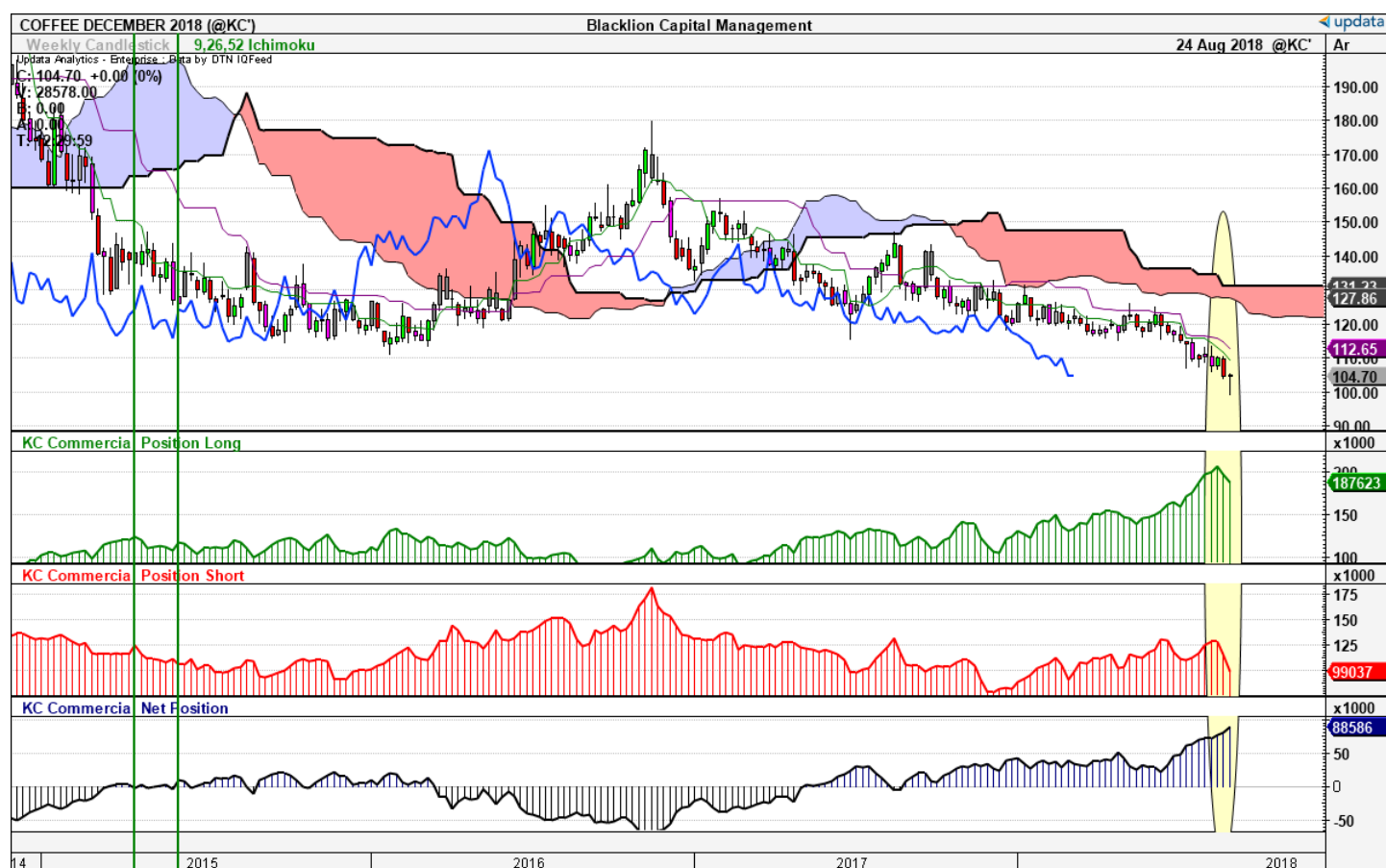


Figure 1 Coffee Commercial Positions; Source: ICE, IQ Feed, CFTC, Udata

Commercials have recently reduced both their long and short positions with a much larger reduction in short positions driving record net long positions among these well-informed market participations. Commercials are positioned for higher prices committing their capital to their fundamental information.

Speculator Position

Commercials are best informed about underlying fundamentals and also positioned to deliver or take delivery of physical commodities and are leading indicators. Large speculators combining 2nd hand fundamental data with technical analysis drive trends with their positions. Extreme speculator positions are contrary indicators. Note large speculators record long positions near the end of 2016 preceded a sharp decline in Arabica Coffee futures.

Large Speculators have driven the more than 16% decline in coffee this year with their record short positions against stable long positions driving a record net short position

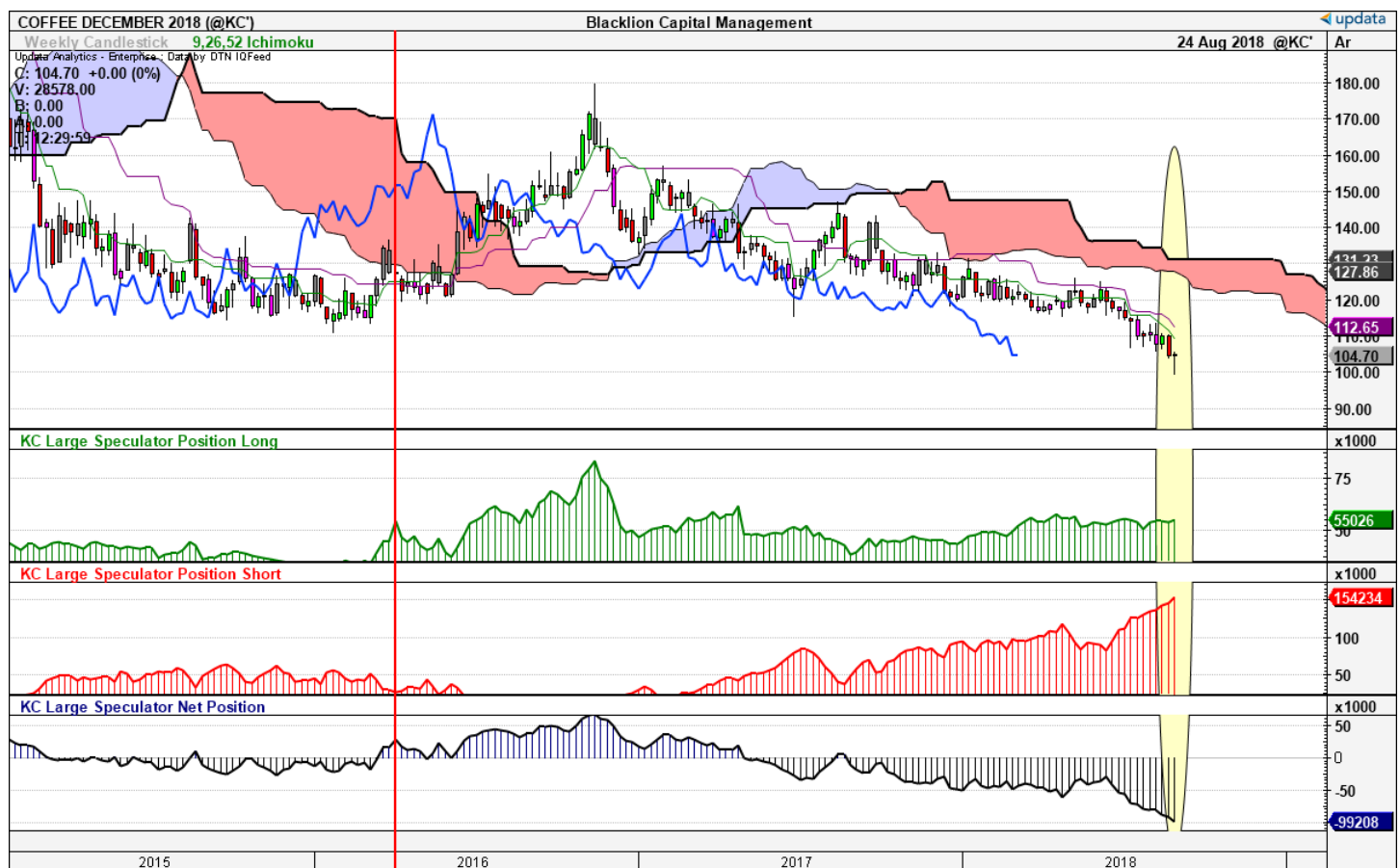


Figure 2 Coffee Large Speculator Positions; Source: ICE, IQ Feed, CFTC, Uputa

Large speculator's **long positions** have remained stable hovering around 55,000 this year in [Figure 2](#) above. Speculators have piled on **short positions** from less than 100,00 to more than 150,000 in recent months.

Speculator's record net short position of 99,208 has been profitable this year, but the majority of the positions have been added during the decline from 117.5 to present with less profit available to absorb a positive reversal before margin concerns motivate offsetting short positions.

Technical Analysis

Coffee's downtrend appears exhausted, but it is important to note the market has not yet experienced extended consolidation and breakout/reversal associated with a confirmed trend change.

Note: This is an ideal time to offset short positions and begin building early speculative longs. This is not a confirmed trend reversal out of consolidation yet and risk must be closely managed while positioning to benefit from inevitable short covering motivated by record net short speculators.

The consolidation process may be volatile, and it is reasonable to expect there may be a test of recent lows.

Weekly Analysis

The initial technical analysis of an exhausted downtrend comes from the weekly chart of COT data. The weekly chart is reproduced below in [Figure 3](#).



Figure 3 Coffee Futures Weekly; Source: ICE, IQ Feed, Udata

Last week's price action generated a rare Bullish Doji Hammer candle stick indicating exhaustion of the trend. The narrow body with long shadow or wick/tail below indicates shorts were able to drive the price lower breaching 100, but the lack of additional sellers resulted in prices closing almost exactly where they opened: 104.7 close after 104.95 open and intra-week 99.35 low.

The inability to close the commodity substantially lower following the long body and log red candle the week before indicates selling exhaustion and speculators should be alert to offset short positions.

Daily Analysis

The daily analysis also offers clues that the downtrend is exhausted.

The daily 3-box reversal point and figure chart in [Figure 4](#) below demonstrates classic downtrend exhaustion realizing/achieving all active downside targets.

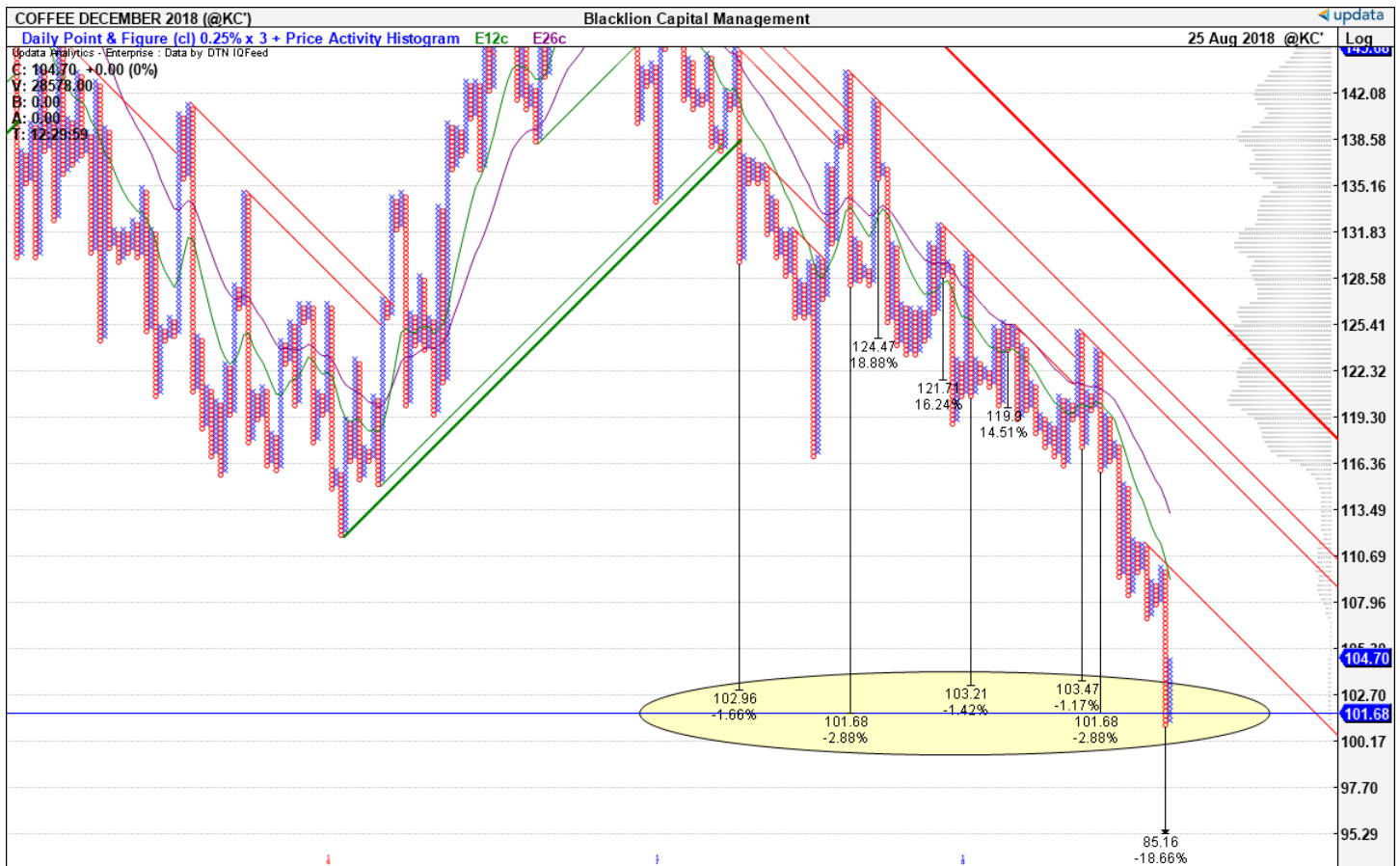


Figure 4 Arabica Coffee Futures Daily P&F; Source: ICE, IQ Feed, Update

While large speculators have built their record short and net short positions the price action generated five (5) active negative targets tightly clustered between 101.68 and 103.47 with two (2) targets at 101.68. Five (5) active targets on a daily P&F chart is rare. For the targets to be clustered so close together over more than a year is even more rare.

Last week's price action realized/achieved all five (5) targets exhausting the existing trend. The 85.16 target on the chart *is not* active and requires a new double bottom sell signal below last week's low to activate.

60-Minute Analysis

Intraday analysis of coffee also confirms exhaustion of the downtrend and reasons to consider a positive reversal in [Figure 5](#) below.

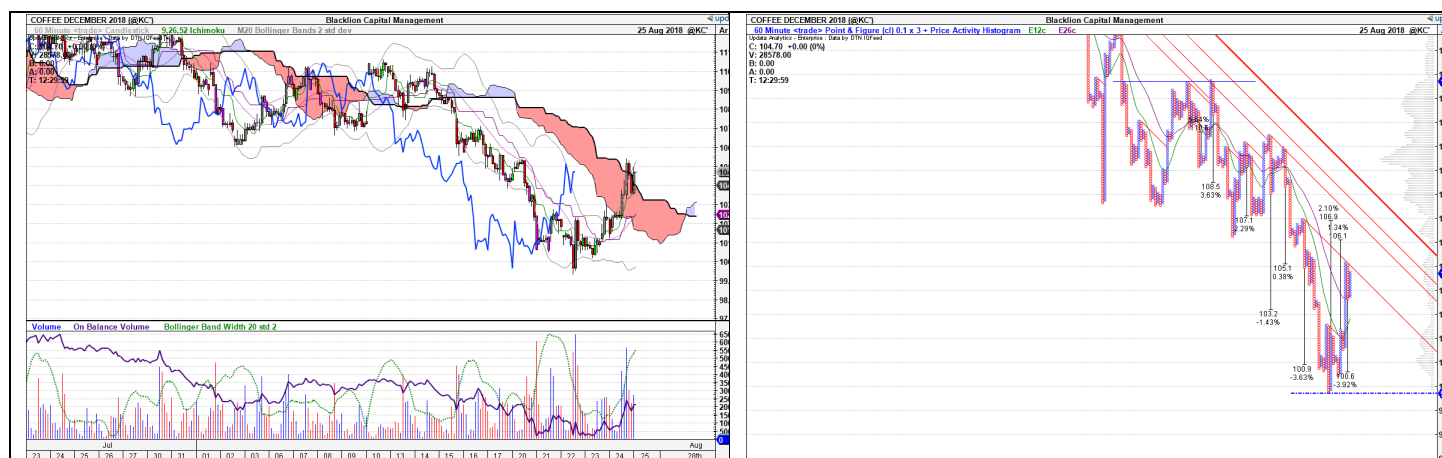


Figure 5 Coffee Futures 60-Minute; Source: ICE, IQ Feed, Update

The 60-minute Ichimoku Cloud chart on the left includes the following near-term bullish indications:

- Clouds reversing to positive at the right edge of the chart
- Turning Line > Standard Line
- Price climbing into the cloud, currently at cloud resistance
- Price reversing up from a Bollinger Band squeeze
- On Balance Volume reversing up

The 60-minute point and figure chart in the right pane of [Figure 5](#) also offers clues to a positive reversal.

- All negative active targets achieved/realized
 - The 100.6 negative target *is not* active. It is possible it will activate during consolidation
- Two (2) consecutive double top buy signals
- Two (2) positive targets activated: 106.1 and 106.9

The Ichimoku Cloud resistance is coincident with point and figure intermediate bearish resistance and it motivates close monitoring for a break above that key level across two analysis techniques.

15-Minute Analysis

Shorter term intraday analysis of December Arabica Coffee futures (KCZ18) revealed even earlier indications of a reversal late last week in [Figure 6](#) below. The 15-minute Ichimoku Cloud analysis is on the left and 3-box point and figure analysis is on the right.

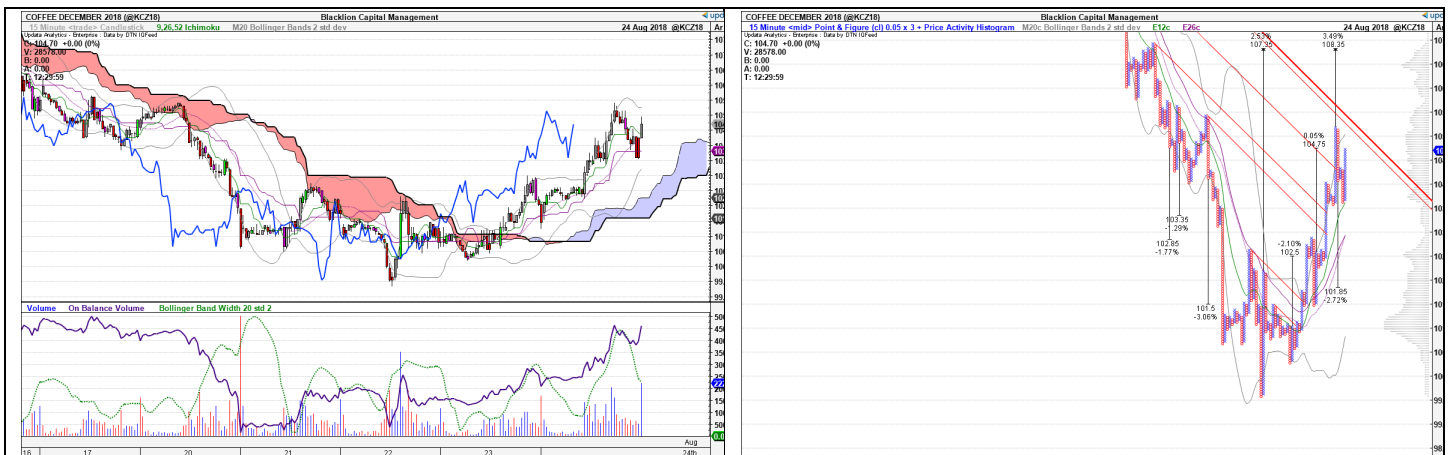


Figure 6 December Coffee Futures KCZ18 15-Minute; Source: ICE, IQ Feed, Update

KCZ18's intraweek low occurred Wednesday August 22nd when it traded below 100 then steadily climbed to Friday settlement. This creates the long shadow wick/tail of the weekly candle in [Figure 3](#). The cloud spans reversed positive, KCZ18 broke above cloud resistance, and was later confirmed by the lagging line breaking above the clouds with steadily improving On Balance Volume in the left pane of [Figure 6](#) above.

The 15-minute 3-box reversal point and figure chart has not completed a bullish reversal, but similar to the 60-minute analysis offers numerous indications of negative trend exhaustion and positive reversal:

- All initial negative targets achieved
 - There is a newly active negative target to 101.85 that is normal in a reversal and early consolidation. Note the new target would be a pullback/correction not a new low.
- Multiple double top buy signals after the 12EMA crossed above the 26EMA
 - The double bottom sell signals are quickly reversed to new highs
- Higher lows and higher highs
- Two (2) positive targets activated and achieved/realized: 102.5 and 104.75
- Active positive target – 107.35 – above bearish resistance
 - 108.35 is not active and requires a double top by signal >105.2 to activate

Additional Intra Week Technical Note

KCZ18 offered an opportunity for a long day trade I mentioned on Twitter on Tuesday in [Figure 7](#) below.

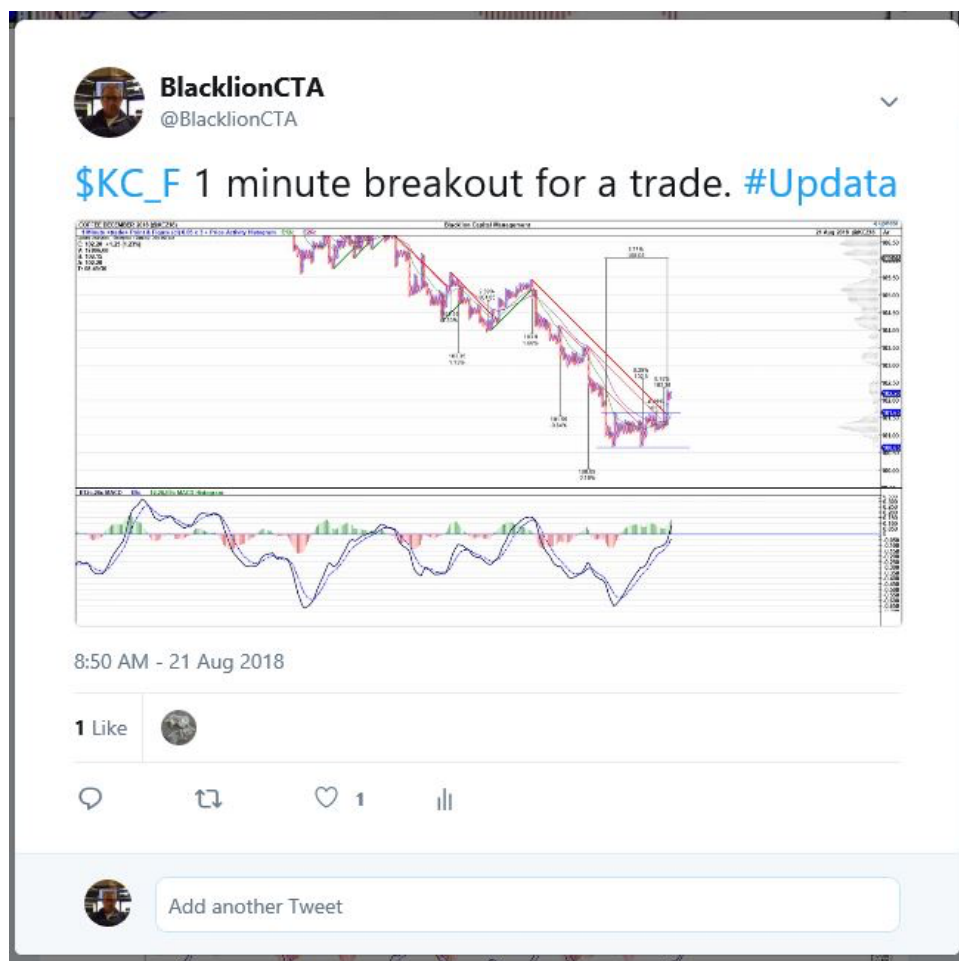


Figure 7 KCZ18 1-Minute Breakout Day Trade; Source @BlacklionCTA

The trade was offset for a small gain as KCZ18 did not put its near-term low in until the next day.

Foreign Exchange Risk

It is always important to consider risk in a trade and in the case of Arabica Coffee FOREX risk merits consideration.

Arabica Coffee is positively correlated to the Brazilian Real detailed in the four panes of [Figure 8](#) below.



Figure 8 Brazilian Real, Coffee Futures Correlation; Source: CME Group, ICE, IQ Feed, Updata

1. The top pane is Brazilian Real futures continuous daily
2. The second pane is daily Arabica Coffee futures
3. Third pane is all time correlation between the two instruments
4. Bottom pane is 65 trading day (90 calendar day) correlation between the instruments.

The positive correlation both long and short term of Arabica Coffee to the Brazilian Real should be considered when managing risk given the recent U.S. Dollar strength and Real weakness.

Trade Recommendation

The primary objective of the trade is to be positioned long for a further and potentially dramatic positive reversal driven by the record short speculators offsetting. Additional consideration should be given to the speculators wherewithal to gradually reduce the record position as coffee consolidates and to be positioned with manageable risk for a possible pullback in consolidation and build a sizeable position. This is just one way to trade this setup and experience and capitalization should be considered in any speculative trading decision.

Contract specifications from ICE: <https://www.theice.com/products/15/Coffee-C-Futures>

Wednesday's intraday low of 99.35 is the guidepost to set a stop for long positions. I recommend setting the stop ~1% below to allow for a retest of the low that may occur. I will use a stop of 98.25 for this risk analysis.

Assuming a Monday open around Friday settlement of 104.7 entering a position there with a 98.25 stop risks \$2,418.75 per contract. The maximum risk in any speculative trade should be no more than 3% of risk capital and consideration should be given here to the FOREX risk. Given that FOREX risk and the likelihood of a pullback to add to an existing position I recommend a maximum risk of 1.5% of capital for an initial position.

Example: a \$500,000 account yields \$7,500 (1.5%) available to risk on the trade or a maximum of 3 contracts. This level of risk is manageable in the current volatile FOREX environment and capital is available to add on a pullback using the same stop and build a position that does not risk more than \$15,000 (3%).

Initial short-term targets from the 15 and 60-minute point and figure charts are 106.1, 106.9, and 107.35. These initial short-term targets do not yield outsize >3:1 reward:risk ratios and contribute to the recommendation for a smaller initial position. Additional consideration can be given to higher/tighter stops for the most agile intraday traders.

Summary

Record COT position data and rare technical indications of trend exhaustion across multiple time frames motivate immediately offsetting short positions and beginning to build a long position for the potentially sharp reversal driven by speculators offsetting record short positions. Consideration must be given to Arabica Coffee's positive correlation to the Brazilian Real in today's volatile FOREX environment.

CFTC Commitment of Traders		Technical Analysis						RISK
Commercial	Speculator	Weekly	Daily P&F	60 Cloud	60 P&F	15 Cloud	15 P&F	FOREX
Record Net Long	Record Short and Net Short	Downtrend Bullish Doji Hammer	Bearish Trend Targets Achieved	Price Rally Into Cloud	+ Targets Buy Signals	Positive Trend +OBV	+ Targets Buy Signals	Brazilian Real